

IN THE UNITED STATES DISTRICT COURT

FOR THE NORTHERN DISTRICT OF CALIFORNIA

No. C 07-05111 CW

CITY OF WESTLAND POLICE AND FIRE
RETIREMENT SYSTEM and PLYMOUTH COUNTY
RETIREMENT SYSTEM, On Behalf of
Themselves and All Others Similarly
Situating,

ORDER GRANTING IN
PART AND DENYING IN
PART DEFENDANTS'
MOTION TO DISMISS

Plaintiffs,

v.

SONIC SOLUTIONS et al.,

Defendants.

Defendants Sonic Solutions, David C. Habiger, Robert J. Doris, A. Clay Leighton, Mary C. Sauer, Mark Ely, Robert M. Greber, Peter J. Marguglio and R. Warren Langley move to dismiss the Consolidated Class Action Complaint (CAC). Lead Plaintiffs City of Westland Police and Fire Retirement System (Westland) and Plymouth County Retirement System (Plymouth) oppose the motion. The motion was heard on February 26, 2009. Having considered all of the parties' papers and oral argument on the motion, the Court grants Defendants' motion in part and denies it in part.

BACKGROUND¹

Defendant Sonic is a California corporation that develops and

¹All facts are taken from Lead Plaintiffs' CAC and are assumed to be true for purposes of this motion.

1 markets computer software related to digital media, such as data,
2 photographs, audio and video in digital formats. Sonic has been a
3 publicly traded company since February, 1994, and is traded on the
4 Nasdaq Global Select Market. Defendants Robert J. Doris and Mary
5 C. Sauer co-founded Sonic in 1986. Doris has been the Chairman of
6 the Board of Directors since the inception of Sonic and he served
7 as the CEO of Sonic from 1986 until he resigned from the position
8 in September, 2005. Sauer has been a Director and Sonic's
9 Secretary since its founding. She also served as the Senior Vice
10 President of Marketing and Sales from February, 1993 to September,
11 2005.

12 Defendants David C. Habiger, A. Clay Leighton, and Mark Ely
13 are executive officers of Sonic. Habiger has worked for Sonic
14 since 1993. In April, 2005, Habiger became President and Chief
15 Operating Officer and, in September, 2005, he succeeded Doris as
16 the CEO. Leighton joined Sonic in 1992 and served as Sonic's Chief
17 Financial Officer from January, 1999 to February, 2008. Ely joined
18 Sonic in 1992 and became an Executive Vice President in September,
19 2006.

20 Defendants Robert M. Greber, R. Warren Langley and Peter
21 Marguglio are outside directors and members of various Board
22 Committees. They joined Sonic's Board in August, 1993, August,
23 1996 and June, 2001, respectively.

24 Lead Plaintiffs Westland and Plymouth purchased Sonic's
25 publicly traded securities between October 23, 2002 and May 17,
26 2007 (Class Period).

27 This case arises out of Defendants' alleged false statements
28 about Sonic's earnings and their concealment of backdated stock

1 option grants. A stock option granted to an employee of a
2 corporation allows the employee to purchase company stock at a
3 specified price (exercise price), typically the fair market value
4 of the stock on the date the option was granted. When the employee
5 exercises an option, he or she purchases the stock from the company
6 at the exercise price, regardless of the stock's price at the time
7 the option is exercised. Backdating occurs when a stock option is
8 reported as having been granted on a certain date, but is actually
9 granted days or months later and is backdated to a date when the
10 company's stock was trading at a lower price. Backdating allows
11 option grantees to realize immediate unearned and undisclosed
12 financial gains. Lead Plaintiffs allege that Defendants altered
13 stock option grants to the Company's officers, directors and
14 employees in order to provide the recipients with a more profitable
15 exercise price. Defendants' statements of Sonic's earnings and
16 expenses were allegedly false because they failed to disclose the
17 backdating of options.

18 On February 1, 2007, Defendants announced an internal
19 investigation into Sonic's past options practices. At the
20 conclusion of the investigation, on February 26, 2008, Defendants
21 announced a \$29 million restatement of Sonic's consolidated
22 financial statements for the fiscal years (FY) from 1998 to 2005 to
23 account for stock option grants which were granted but never
24 documented properly.

25 In the restatement, Sonic stated that "a substantial number of
26 stock options granted during the review period were not correctly
27 accounted for." The company explained that "option grant
28 agreements were typically dated 'as of' with no separate date for

1 the signature of a Company officer, and Company personnel indicated
2 that these agreements were typically generated as part of the end-
3 of-quarter reporting cycle notwithstanding the Record Date
4 appearing on the documents themselves." The restatement also
5 noted,

6 Under each of our various options plans, our CEO was
7 delegated the authority to make grants to employees
8 other than executive officers. As described above,
9 except in particular circumstances . . . the Company
10 employed a quarterly-focused grant process for non-
11 founder employees and generally lack[ed]
12 contemporaneous grant documents sufficient to support
13 the Record Dates for these option grants.

14 . . .

15 The Audit Committee noted instances in which personnel
16 actively discussed how to correct mistakes related to
17 the documentation and related accounting treatment, and
18 when to inform auditors of those mistakes.

19 . . .

20 Prior to September 23, 2005, our CEO [Doris] would
21 typically make grants to our non-founder executive
22 officer(s) who are considered "executive officers" for
23 purposes of Section 16 of the Exchange Act in the same
24 manner as he would for non-executive employees of the
25 Company. Pursuant to the delegation to him under our
26 various option plans, the CEO [Doris] generally did not
27 have express authority to grant options to Section 16
28 officers, as this power was reserved for the board.
Nevertheless, these grants were made in a consistent
fashion and it is apparent that our board was aware of
these option grants and did not disapprove of them. . .

The restatement also concluded, "After reviewing the available
documentary evidence and information gathered through interviews of
Company personnel, the Audit Committee concluded that the conduct
of those who administered our options plans was not intentionally
or knowingly wrongful." The restatement reported that the Audit
Committee also "found no indication of intent to purposefully
circumvent stock option accounting rules or to otherwise

1 inaccurately report the financial results of the Company during the
2 Review Period."

3 Westland filed the initial complaint in this case on October
4 4, 2007, eight months after Defendants announced their internal
5 investigation. Following Defendants' restatement in February,
6 2008, Westland, joined by Plymouth, filed a Consolidated Class
7 Action Complaint. Lead Plaintiffs allege that Defendants violated
8 Sections 10(b), 14(a), 20(a) and 20A of the Exchange Act and Rule
9 10b-5.

10 LEGAL STANDARD

11 A complaint must contain a "short and plain statement of the
12 claim showing that the pleader is entitled to relief." Fed. R.
13 Civ. P. 8(a). On a motion under Rule 12(b)(6) for failure to state
14 a claim, dismissal is appropriate only when the complaint does not
15 give the defendant fair notice of a legally cognizable claim and
16 the grounds on which it rests. See Bell Atl. Corp. v. Twombly,
17 550 U.S. 554, 127 S. Ct. 1955, 1964 (2007).

18 In considering whether the complaint is sufficient to state a
19 claim, the court will take all material allegations as true and
20 construe them in the light most favorable to the plaintiff. NL
21 Indus., Inc. v. Kaplan, 792 F.2d 896, 898 (9th Cir. 1986).

22 Although the court is generally confined to consideration of the
23 allegations in the pleadings, when the complaint is accompanied by
24 attached documents, such documents are deemed part of the complaint
25 and may be considered in evaluating the merits of a Rule 12(b)(6)
26 motion. Durning v. First Boston Corp., 815 F.2d 1265, 1267 (9th
27 Cir. 1987).

28 When granting a motion to dismiss, the court is generally

1 required to grant the plaintiff leave to amend, even if no request
2 to amend the pleading was made, unless amendment would be futile.
3 Cook, Perkiss & Liehe, Inc. v. N. Cal. Collection Serv. Inc., 911
4 F.2d 242, 246-47 (9th Cir. 1990). In determining whether amendment
5 would be futile, the court examines whether the complaint could be
6 amended to cure the defect requiring dismissal "without
7 contradicting any of the allegations of [the] original complaint."
8 Reddy v. Litton Indus., Inc., 912 F.2d 291, 296 (9th Cir. 1990).

9 REQUESTS FOR JUDICIAL NOTICE

10 Defendants seek judicial notice of Exhibits A, B and 1-3 to
11 their request. Federal Rule of Evidence 201 allows a court to take
12 judicial notice of a fact "not subject to reasonable dispute in
13 that it is . . . capable of accurate and ready determination by
14 resort to sources whose accuracy cannot reasonably be questioned."
15 Even where judicial notice is not appropriate, courts may also
16 properly consider documents "whose contents are alleged in a
17 complaint and whose authenticity no party questions, but which are
18 not physically attached to the [plaintiff's] pleadings." Branch v.
19 Tunnell, 14 F.3d 449, 454 (9th Cir. 1994).

20 Having reviewed the exhibits, the Court denies Defendants'
21 request as to Exhibits A, B, 1 and 2 because the information
22 contained in these SEC filings is disputed by Lead Plaintiffs. Lee
23 v. City of Los Angeles, 250 F.3d 668, 690 (9th Cir. 2001) (holding
24 that a court may not take judicial notice of "disputed facts in
25 public records."). The Court will not accept as true the matters
26 asserted in those documents. The Court grants Defendants' request
27 as to Exhibit 3 because historic stock prices are subject to
28 accurate and ready determination by resort to sources whose

1 accuracy cannot reasonably be questioned.

2 DISCUSSION

3 I. Section 10(b) of the Exchange Act and Rule 10b-5

4 Section 10(b) of the Exchange Act makes it unlawful for any
5 person to "use or employ, in connection with the purchase or sale
6 of any security . . . any manipulative or deceptive device or
7 contrivance in contravention of such rules and regulations as the
8 [SEC] may prescribe." 15 U.S.C. § 78j(b); see also 17 C.F.R.
9 § 240.10b-5 (Rule 10b-5). To state a claim under § 10(b), a
10 plaintiff must allege: "(1) a misrepresentation or omission of
11 material fact, (2) reliance, (3) scienter, and (4) resulting
12 damages." Paracor Fin., Inc. v. Gen. Elec. Capital Corp., 96 F.3d
13 1151, 1157 (9th Cir. 1996); see also McCormick v. Fund Am. Cos., 26
14 F.3d 869, 875 (9th Cir. 1994).

15 Some forms of recklessness are sufficient to satisfy the
16 element of scienter in a § 10(b) action. See Nelson v. Serwold,
17 576 F.2d 1332, 1337 (9th Cir. 1978). Within the context of § 10(b)
18 claims, the Ninth Circuit defines "recklessness" as

19 a highly unreasonable omission [or misrepresentation],
20 involving not merely simple, or even inexcusable
21 negligence, but an extreme departure from the standards
22 of ordinary care, and which presents a danger of
misleading buyers or sellers that is either known to the
defendant or is so obvious that the actor must have been
aware of it.

23 Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1569 (9th Cir.
24 1990) (en banc) (quoting Sundstrand Corp. v. Sun Chem. Corp., 553
25 F.2d 1033, 1045 (7th Cir. 1977)). As explained by the Ninth
26 Circuit in In re Silicon Graphics Inc. Securities Litigation, 183
27 F.3d 970 (9th Cir. 1999), recklessness, as defined by Hollinger, is
28 a form of intentional conduct, not merely an extreme form of

1 negligence. See Silicon Graphics, 183 F.3d at 976-77. Thus,
2 although § 10(b) claims can be based on reckless conduct, the
3 recklessness must "reflect[] some degree of intentional or
4 conscious misconduct." See id. at 977. The Silicon Graphics court
5 refers to this subspecies of recklessness as "deliberate
6 recklessness." See id. at 977.

7 Lead Plaintiffs must plead any allegations of fraud with
8 particularity, pursuant to Rule 9(b) of the Federal Rules of Civil
9 Procedure. In re GlenFed, Inc. Sec. Litig., 42 F.3d 1541, 1543
10 (9th Cir. 1994) (en banc). Pursuant to the requirements of the
11 Private Securities Litigation Reform Act of 1995 (PSLRA), the
12 complaint must "specify each statement alleged to have been
13 misleading, the reason or reasons why the statement is misleading,
14 and, if an allegation regarding the statement or omission is made
15 on information and belief, the complaint shall state with
16 particularity all facts on which that belief is formed." 15 U.S.C.
17 § 78u-4(b)(1).

18 Further, pursuant to the requirements of the PSLRA, a
19 complaint must "state with particularity facts giving rise to a
20 strong inference that the defendant acted with the required state
21 of mind." 15 U.S.C. § 78u-4(b)(2). The PSLRA thus requires that a
22 plaintiff plead with particularity "facts giving rise to a strong
23 inference that the defendant acted with," at a minimum, deliberate
24 recklessness. See 15 U.S.C. § 78u-4(b)(2); Silicon Graphics, 183
25 F.3d at 977. Facts that establish a motive and opportunity, or
26 circumstantial evidence of "simple recklessness," are not
27 sufficient to create a strong inference of deliberate recklessness.
28 See Silicon Graphics, 183 F.3d at 979. In order to satisfy the

1 heightened pleading requirement of the PSLRA for scienter,
2 plaintiffs "must state specific facts indicating no less than a
3 degree of recklessness that strongly suggests actual intent." Id.

4 A. Requisite Mental State

5 Thus, to state a claim pursuant to § 10(b) of the Exchange
6 Act, Lead Plaintiffs must "plead 'a highly unreasonable omission,
7 involving not merely simple, or even inexcusable negligence, but an
8 extreme departure from the standards of ordinary care, and which
9 presents a danger of misleading buyers or sellers that is either
10 known to the defendant or is so obvious that the actor must have
11 been aware of it.'" Zucco Partners v. Digimarc Corp., 552 F.3d
12 981, 991 (9th Cir. 2009) quoting Silicon Graphics, 183 F.3d at 976.
13 If no individual allegations are sufficient, then the Court will
14 "conduct a 'holistic' review of the same allegations to determine
15 whether the insufficient allegations combine to create a strong
16 inference" of scienter. Id.

17 Defendants argue that Lead Plaintiffs' allegations, when
18 examined alone or considered holistically, are insufficient to give
19 rise to a strong inference of scienter. Lead Plaintiffs counter
20 that nine different sources of evidence support such an inference:
21 (1) Defendants' admissions, (2) the magnitude of the accounting
22 violations, (3) Defendants' receipt of backdated options, (4) the
23 timing of the backdated options, (5) Defendants' filing of false
24 documents with the SEC, (6) the Board of Directors' actions,
25 (7) the importance of the stock options program, (8) Defendants'
26 insider trading and (9) the timing of Defendant Leighton's
27 termination as CFO. The Court addresses these contentions in turn.

28

1 1. Defendants' Admissions

2 Lead Plaintiffs argue that, in the restatement, Defendants
3 admitted to conduct that supports a strong inference of scienter.
4 Specifically, the restatement notes that "option grants were
5 typically dated 'as of' with no separate date for the signature of
6 a Company officer, and Company personnel indicated that these
7 agreements were typically generated as part of the end-of-quarter
8 reporting cycle, notwithstanding the Record Date appearing on the
9 document themselves." Lead Plaintiffs argue that this means that
10 the option was not "granted" on the date that it was approved by
11 the Board or CEO, but instead dated to reflect an effective date
12 "as of" a date that had already passed. Defendants counter that
13 because the Audit Committee concluded that no intentional
14 misconduct occurred, any evidence of backdating should be seen as
15 the result of "innocent but sloppy accounting practices," and that
16 "not each and every single instance where a company has chosen the
17 wrong measurement date is necessarily a case of backdating." In re
18 Zoran Corp. Deriv. Litig. 511 F. Supp. 2d 986, 1003-04 (N.D. Cal.
19 2007). However, here, Lead Plaintiffs do not assert merely one or
20 two stock options that contain an incorrect measurement date. In
21 other filings submitted to the SEC, Defendants noted that "for a
22 large portion of options issued . . . there is little to no
23 contemporaneous grant-specific documentation that satisfies the
24 requirements for 'measurement dates' under APB No. 25."² CAC

25
26 ²APB No. 25 is the acronym for Accounting Principles Board
27 Opinion No. 25. Issued in 1972, APB No. 25 provides guidelines for
28 the expensing of options granted by a company to its employees. In
1973, APB became the Financial Accounting Standards Board, which is
(continued...)

¶ 123. Further, Defendants cannot fairly rely on the Audit Committee's statement that no intentional misconduct occurred because the members of the Audit Committee are the same people responsible for overseeing the option backdating process. ¶ 136. In sum, Defendants' statements about their stock options practice provide some insight into their state of mind, but do not give rise to a strong inference of scienter.

2. The Magnitude of Defendants' Accounting Violations

Lead Plaintiffs argue that Defendants' \$29 million restatement, which proved that Defendants' earlier SEC filings were inaccurate and in violation of Generally Accepted Accounting Principles (GAAP), supports an inference of scienter. See In re Daou Sys., Inc. Sec. Litig., 411 F.3d 1006, 1016 (9th Cir. 2005) ("Violations of GAAP standards can also provide evidence of scienter."); In re McKesson HBOC, Inc. Sec. Litig., 126 F. Supp. 2d 1248, 1273 (N.D. Cal. 2000) (In re McKesson) ("when significant GAAP violations are described with particularity in the complaint, they may provide powerful indirect evidence of scienter. After all, books do not cook themselves."). Defendants do not dispute that throughout the Class Period they failed to comply with APB No. 25 when they backdated stock options. However, Defendants argue that they did so unknowingly. They argue that, until recent years, few companies understood the relevance of or how to apply APB No. 25. Defendants state that it is "an unsubstantiated stretch of the imagination to argue that executives recognized [APB No. 25's]

²(...continued)
a leading organization in the private sector for establishing standards of financial accounting and reporting in the United States.

1 importance in the late 1990s and early 2000s."

2 In a September, 2006 letter issued by the SEC which describes
3 how APB No. 25 should be applied, the SEC stated:

4 The existence of a pattern of past option grants with an
5 exercise price equal to or near the lowest price of the
6 entity's stock during the time period surrounding those
7 grants could indicate that the terms of those grants
8 were determined with hindsight. Further, in some cases,
9 the absence of documentation, in combination with other
10 relevant factors, may provide evidence of fraudulent
11 conduct.

12 CAC ¶ 44.

13 Yet, courts have concluded that APB No. 25 is a complex rule, and
14 that a misapplication of APB No. 25 "cannot be construed as a
15 glaring example of scienter because the measurement date criteria
16 embodied in APB No. 25 are far from obvious." Weiss v. Amkor
17 Tech., Inc., 527 F. Supp. 2d 938, 949 (D. Ariz. 2007); see In re
18 Sportsline.com Sec. Litig., 366 F. Supp. 2d 1159, 1168-69 (S.D.
19 Fla. 2004) ("interpretations of the measurement date criteria
20 embodied in APB No. 25 are far from obvious"). Also, the \$29
21 million amount in the restatement is not glaringly high given that
22 it applies to a ten-year period. Courts have concluded that
23 restatements of amounts far greater than \$29 million do not
24 establish scienter. See In re Marvell Tech. Group Ltd. Sec.
25 Litig., 2008 WL 4544439, at *6 (N.D. Cal. Sept. 29) ("plaintiffs
26 cannot show scienter solely by pointing to the fact that Marvell
27 restated its financial statements [by \$327.4 million in stock-based
28 compensation expenses]"); Weiss, 527 F. Supp. 2d at 942 (dismissing
a stock option backdating case where the restatement was \$106
million). Though the magnitude of Defendants' accounting violation
alone does not demonstrate scienter, together with other

1 allegations, it could amount to the requisite mental state.

2 3. Defendants' Receipt of Backdated Options

3 Lead Plaintiffs argue that the receipt of backdated options by
4 Defendants Doris, Sauer and Leighton supports a strong inference of
5 scienter on their part. For instance, Lead Plaintiffs allege that
6 Defendant Leighton received at least 440,000 backdated options from
7 which he immediately realized earnings when the options were filed.
8 See Middlesex Ret. Sys. v. Quest Software, Inc., 527 F. Supp. 2d
9 1164, 1183 (C.D. Cal. 2007) ("it is simply incomprehensible that
10 for such large option grants Defendants would not have been keenly
11 aware of the option measurement date and the resulting value of the
12 option grants"); In re Affymetrix Deriv. Litig., 2008 U.S. Dist.
13 LEXIS 97245, at *21 (N.D. Cal. Oct. 24) (concluding that
14 allegations that defendants received backdated options "support an
15 inference that [those defendants] had knowledge of and participated
16 in the backdating of the options because they had a significant
17 financial interest in doing so"). However, Defendants counter that
18 these option grants were only a small subset of the grants that
19 Leighton received while he worked at Sonic and, therefore, do not
20 support any inference of scienter. Further, Defendants argue that
21 if the backdating had been done intentionally, they would have
22 picked even more advantageous dates, dates on which the stock was
23 trading even lower than on the ones recorded. Defendants also
24 argue that the grants to Doris and Sauer are irrelevant because
25 they occurred outside of the class period. This last argument is
26 not well-taken because the class period is defined by the dates of
27 Defendants' alleged false statements, not the option grant dates.
28 In re Openwave Sys. Sec. Litig., 528 F. Supp. 2d 236, 250 (S.D.N.Y.

1 2007) ("it is irrelevant that the options were received before the
2 class period. The accounting for the backdated options affected
3 every financial statement until those options vested."). While
4 standing alone, the receipt of backdated options by individual
5 Defendants does not necessarily support a strong inference of those
6 Defendants' scienter, it does provide some support for that
7 conclusion.

8 4. Timing of the Backdated Options

9 Lead Plaintiffs argue that the timing of the backdating was
10 "so fortuitous that intentional retroactive selection of such
11 grants is the only reasonable inference that can be drawn."
12 Opposition at 17. Lead Plaintiffs claim that, based on all
13 publicly available documents regarding Sonic's option grants, the
14 Company made fourteen discretionary grants between 1996 and 2004.³
15 Eight grants were purportedly made on dates when its stock was
16 trading at its lowest point in the relevant month. Lead Plaintiffs
17 assert that, "according to a statistical analysis performed by
18 Professor Eric Lie, the odds of this happening by chance are 1 in
19 11 million." Opposition at 17 (emphasis in original); see also CAC

20 ¶ 9. Defendants counter that this statistical claim is spurious
21 because nothing in the complaint describes how the calculation was
22 made nor how Lead Plaintiffs determined which "grants among the
23 thousands made by Sonic during the class period were
24 'discretionary'." Reply at 7. In the absence of further

26 ³Lead Plaintiffs note that, in total, "Sonic made 24 grants
27 between 1996 and 2004, but at least ten of those grants were non-
28 discretionary grants awarded under Sonic's non-employee director
plan, under which grant dates could not be manipulated."
Opposition at 17 n.10.

1 information as to why these fourteen grants are distinguishable
2 from thousands of other grants made by Sonic, these fourteen grants
3 must be viewed as a small unrepresentative sample of all stock
4 option grants. Further, the claim that many of these grants were
5 made at the lowest point of the month may be misleading because, in
6 some instances, the stock traded at the same price or lower several
7 times in a month. If Defendants were actively selecting grant
8 dates with the intent to maximize their earnings, they would have
9 selected more favorable dates. Absent a clearer showing, the grant
10 dates themselves provide little evidence from which to make an
11 inference scienter.

12 5. Filing of False Documents with the SEC

13 Lead Plaintiffs argue that each time Defendants signed false
14 SEC filings, Sarbanes-Oxley (SOX) certificates and financial
15 statements they knew or at least were "deliberately reckless in not
16 knowing that stock options were not being issued at fair market
17 value on the date of the grant." See Zoran, 511 F. Supp. 2d at
18 1013. However, standing alone, these filings do not give rise to a
19 strong inference of scienter. Zucco Patners LLC v. Digimarc Corp.,
20 2009 WL 311070, at *18 ("Sarbanes-Oxley certifications are not
21 enough to create a strong inference of scienter and do not make
22 [plaintiff's] otherwise insufficient allegations more compelling by
23 their presence in the same complaint."); Brodsky v. Yahoo! Inc.,
24 2008 WL 4531815, at *10 (N.D. Cal. Oct. 7) ("Without any supporting
25 allegations that Defendants made false accounting entries or
26 inflated revenues, Defendants' signatures on the SEC certificates
27 do not create a strong inference of scienter."). However, in
28 conjunction with the fact that many Defendants personally received

1 backdated stock options, their signed false SEC and SOX documents
2 provide some evidence of scienter.

3 6. Board of Directors' Actions

4 With respect to stock option grants to Sonic's non-founding
5 executive officers, the restatement noted that "the CEO generally
6 did not have express authority to grant options to [them], as this
7 power was reserved for the board. Nevertheless, these grants were
8 made in a consistent fashion and it is apparent that our board was
9 aware of these option grants and did not disapprove of them." CAC

10 ¶ 53. Lead Plaintiffs point to this section of the restatement as
11 evidence that the entire Board of Directors participated in a
12 scheme to backdate stock options. However, the restatement refers
13 to actions the CEO took with respect to granting stock options to
14 non-founding executive officers, without first getting the approval
15 of the Board. The restatement does not acknowledge that the Board
16 knowingly participated in illegally backdating stock options.

17 7. The Importance of the Stock Options Program

18 Lead Plaintiffs contend that, because the stock options
19 program was "of fundamental importance to the Company's success,"
20 there is a strong inference that Defendants knew or were
21 deliberately reckless in not knowing that they acted illegally by
22 not correctly disclosing backdated options to the SEC. In essence,
23 Lead Plaintiffs argue that stock options were critical to Sonic's
24 "core operations." South Ferry LP v. Killinger, 542 F.3d 776, 785
25 (9th Cir. 2008) ("Where a complaint relies on allegations that
26 management had an important role in the company but does not
27 contain additional detailed allegations about the defendants'
28 actual exposure to information, it will usually fall short of the

1 PSLRA standard. . . However, in some unusual circumstances, the
2 core operations inference, without more, may raise the strong
3 inference required by the PSLRA"). Here, the stock options program
4 was not part of Sonic's core operation, which was the business of
5 manufacturing and selling digital media products. While Defendants
6 no doubt knew that they granted stock options as part of Sonic's
7 benefits packages, not enough facts have been alleged to support a
8 strong inference that, simply because of the importance of the
9 stock option plans and Defendants' position in the company, they
10 knew accounting policies were being violated.

11 8. Defendants' Insider Trading

12 Lead Plaintiffs argue that Defendants' sales of \$23 million
13 worth of Sonic stock during the Class Period contribute to a strong
14 inference of scienter. However, Lead Plaintiffs have not plead
15 specific facts to show that these sales were unusual or suspicious,
16 including: "(1) the amount and percentage of shares sold by
17 insiders; (2) the timing of the sales; and (3) whether the sales
18 were consistent with the insider's prior trading history." Zucco,
19 2009 WL 311070, at *19. Lead Plaintiffs claim that these three
20 factors are not relevant in the backdating context because of the
21 long duration of the fraud. Quest, 527 F. Supp. 2d at 1185. Even
22 if these factors are not relevant, Lead Plaintiffs have not plead
23 with particularity any other facts that would show how Defendants'
24 insider trading supports a strong inference of scienter.

25 9. The Timing of Defendant Leighton's Termination as CFO

26 On February 25, 2008, shortly after Sonic completed its
27 internal investigation, Defendant Leighton changed positions from
28 CFO to COO. Lead Plaintiffs argue that this move supports a strong

1 inference of scienter because Defendant Leighton was partly
2 responsible for and a direct recipient of backdated stock options.
3 However, Lead Plaintiffs do not plead any facts to show that the
4 Board moved Defendant Leighton from one top management position to
5 another top management position because he engaged in fraud. See
6 In re U.S. Aggregates, Inc. Sec. Litig., 235 F. Supp. 2d 1063, 1074
7 (N.D. Cal. 2002) ("after a restatement of earnings and a subsequent
8 loan default, it is unremarkable that the Company would seek to
9 change its management team"); Zucco, 2009 WL 311070, at *16 ("Where
10 a resignation occurs slightly before or after the defendant
11 corporation issues a restatement, a plaintiff must plead facts
12 refuting the reasonable assumption that the resignation occurred as
13 a result of restatement's issuance itself.").

14 In sum, Lead Plaintiffs' allegations do not create a strong
15 inference that Defendants acted with scienter. Several factors do
16 lend support for the requisite mental state, such as Defendants'
17 admissions, the magnitude of Defendants' accounting violations,
18 Defendants' receipt of backdated options and Defendants' filing of
19 false documents with the SEC. However, even when viewed
20 cumulatively, these factors do not establish a strong inference
21 that Defendants acted with deliberate recklessness. Therefore,
22 Lead Plaintiffs have not adequately alleged that Defendants
23 violated § 10(b) of the Exchange Act and Rule 10b-5.

24 II. Section 14(a) of the Exchange Act

25 Rule 14a-9, promulgated pursuant to § 14(a) of the Exchange
26 Act, provides that no proxy statement shall contain "any statement
27 which, at the time and in the light of the circumstances under
28 which it is made, is false or misleading with respect to any

1 material fact, or which omits to state any material fact necessary
2 in order to make the statements therein not false or misleading."
3 17 C.F.R. § 240.14a-9.

4 The statute of limitations for claims under § 14(a) is the
5 earlier of one year after the discovery of the violation, or three
6 years after the alleged violation. See In re Asyst Tech, Inc.
7 Deriv. Litig., 2008 WL 2169021, at *5 (N.D. Cal.); Rudolph v.
8 UTStarcom, 2008 WL 1734763 (N.D. Cal.). Plaintiff Westland filed
9 this complaint on October 4, 2007, making its § 14(a) claim
10 time-barred as to proxy statements issued on July 29, 2003 and July
11 27, 2004. However, the claim based on Defendants' proxy statement
12 filed on October 24, 2005 is not time-barred.

13 To plead a § 14(a) violation, a plaintiff must allege that
14 (1) a proxy statement contained a material misrepresentation or
15 omission, (2) the misstatement or omission was made with the
16 requisite level of culpability and (3) the misstatement or omission
17 was an essential link in the accomplishment of the proposed
18 transaction. Desaiqouadar v. Meyercord, 223 F.3d 1020, 1022 (9th
19 Cir. 2000). The requisite level of culpability is negligence. In
20 re McKesson, 126 F. Supp. 2d at 1265-66.

21 Here, Lead Plaintiffs have adequately alleged that the 2005
22 proxy statement omitted the material facts that Defendants had
23 failed properly to account for backdated options. Although Lead
24 Plaintiffs' allegations do not support a strong inference of
25 deliberate recklessness, they do support a strong inference that
26 Defendants were negligent in failing to discover, stop or disclose
27 the alleged backdating scheme. Defendants, as senior executives,
28 Board members and Audit Committee members, had duties associated

1 with administering and accounting the stock option plans, granting
2 the stock options and approving Sonic's financial reports and proxy
3 statements. See ¶¶ 24, 53, 61, 63, 65-67, 101, 121, 125, 128, 136.
4 Defendants were also responsible for ensuring that Sonic's public
5 statements describing and accounting for these options were
6 truthful and accurate. Therefore, Lead Plaintiffs' allegations are
7 sufficient to raise an inference that Defendants knew or should
8 have known that Sonic's proxy statement was false.

9 Lead Plaintiffs have also adequately alleged that the omission
10 in the proxy statement was an essential link in the accomplishment
11 of the proposed transaction. Lead Plaintiffs' complaint alleges
12 that "revelations of the truth [of backdated stock options] would
13 have immediately thwarted a continuation of shareholders'
14 endorsement of the directors' positions, the executive officers'
15 compensation and the Company's compensation policies." CAC ¶ 214.
16 See also, Belova v. Sharp, 2008 WL 700961 (D. Or. March 13); Zoran,
17 511 F. Supp. 2d at 1016; In re Maxim Integrated Prods., Inc.
18 Derivative Litig., 574 F. Supp. 2d 1046, 1066-67 (N.D. Cal. 2008).
19 Standing for election as directors based on these proxy statements
20 constitutes a proposed transaction.

21 III. Section 20(a) of the Exchange Act

22 Lead Plaintiffs allege control person liability against
23 Defendants based on § 20(a) of the Exchange Act, which states,
24 "Every person who, directly or indirectly, controls any person
25 liable under any provision of this chapter or of any rule or
26 regulation thereunder shall also be liable jointly and severally
27 with and to the same extent as such controlled person to any person
28 to whom such controlled person is liable, unless the controlling

1 person acted in good faith and did not directly or indirectly
2 induce the act or acts constituting the violation or cause of
3 action." 15 U.S.C. § 78t(a). To prove a prima facie case under
4 § 20(a), a plaintiff must prove: 1) "a primary violation of federal
5 securities law"; and 2) "that the defendant exercised actual power
6 or control over the primary violator." Howard v. Everex Sys.,
7 Inc., 228 F.3d 1057, 1065 (9th Cir. 2000). "[I]n order to make out
8 a prima facie case, it is not necessary to show actual
9 participation or the exercise of power; however, a defendant is
10 entitled to a good faith defense if he can show no scienter and an
11 effective lack of participation." Id. "Whether [the defendant] is
12 a controlling person is an intensely factual question, involving
13 scrutiny of the defendant's participation in the day-to-day affairs
14 of the corporation and the defendant's power to control corporate
15 actions." Id.

16 The complaint does not allege any specific facts supporting a
17 conclusion that Defendants are controlling persons of Sonic. The
18 entirety of the relevant allegations is contained in the following
19 paragraphs:

20 Defendants acted as controlling persons of Sonic within
21 the meaning of § 20(a) of the Exchange Act. By reason of
22 their positions with the Company, and their ownership of
23 Sonic stock, defendants had the power and authority to
24 cause Sonic to engage in the wrongful conduct complained
of herein. Sonic controlled defendants and all of its
employees. By reason of such conduct, defendants named
herein are liable pursuant to § 20(a) of the Exchange
Act.

25 CAC ¶¶ 217. These paragraphs consist of bare legal conclusions and
26 are devoid of any factual underpinnings. Accordingly, the
27 complaint does not state a claim against Defendants.
28

1 IV. Section 20A of the Exchange Act

2 Lead Plaintiffs also allege that Defendants Doris, Sauer, Ely,
3 Greber, Langley, Leighton and Marguglio violated § 20A of the
4 Exchange Act, which states, "Any person who violates any provision
5 of this chapter or the rules or regulations thereunder by
6 purchasing or selling a security while in possession of material,
7 nonpublic information shall be liable in an action in any court of
8 competent jurisdiction to any person who, contemporaneously with
9 the purchase or sale of securities that is the subject of such
10 violation, has purchased . . . securities of the same class." 15
11 U.S.C. § 78t-1.

12 Defendants argue that Lead Plaintiffs did not trade
13 "contemporaneously" with Defendants. The term "contemporaneous" is
14 inherently vague. Moreover, Congress did not intend precisely to
15 define "'contemporaneous as used in § 20A', but instead apparently
16 intended to adopt the definition 'which has developed through the
17 case law.'" Neubronner v. Milken, 6 F.3d 666, 669 n.5 (9th Cir.
18 1993) (citing H.R. Rep. No. 910, 100 Cong., 2d Sess. 27 (1988)).
19 The Ninth Circuit has not provided clear guidance on this issue.
20 In Neubronner, the Ninth Circuit specifically refrained from
21 determining the "exact contours of 'contemporaneous trading' . . ."
22 Neubronner, 6 F.3d at 670. The court did, however, explain that
23 "the contemporaneous trading rule ensures that only private parties
24 who have traded with someone who had an unfair advantage will be
25 able to maintain insider trading claims." Id.

26 Defendants assert that, to be contemporaneous, Lead
27 Plaintiffs' trading must have occurred on the same day as
28 Defendants'. See, e.g., Buban v. O'Brien, 1994 WL 324093, at *2

1 (N.D. Cal. June 22); In re AST Research Sec. Litig., 887 F. Supp.
2 231, 233 (C.D. Cal. 1995). Interpreting "contemporaneous" so
3 strictly increases the likelihood that a plaintiff purchased the
4 actual shares sold by the insider. As the time between the
5 insider's sale and the plaintiff's purchase increases, the
6 likelihood that the shares purchased by the plaintiff are the same
7 shares the insider sold decreases substantially.

8 Here, Lead Plaintiffs have alleged that they purchased Sonic
9 shares on the same day that Defendants Doris and Leighton sold
10 shares, one day after Defendant Langley sold shares, and nine days
11 after Defendant Greber sold shares. Although the purchase of stock
12 nine days after a sale pushes the contours of contemporaneousness,
13 the Court concludes that all of these purchases are contemporaneous
14 with the sales. See Middlesex, 527 F. Supp. 2d at 1194-96 (holding
15 that the plaintiff's allegation that it traded "on the same day as
16 Smith, within eight days of Garn, and within three days of Brooks"
17 was sufficient to deny the defendants' motion to dismiss the § 20A
18 claims.). The Court notes that Lead Plaintiffs failed to allege
19 that Defendants Sauer, Ely and Marguglio sold stock
20 contemporaneously with Lead Plaintiffs' purchases. Therefore, the
21 § 20A claims against those Defendants are dismissed.

22 CONCLUSION

23 For the foregoing reasons, the Court GRANTS in part
24 Defendants' motion to dismiss Lead Plaintiffs' CAC (Docket No. 67).
25 The Court grants Lead Plaintiffs leave to amend their CAC in
26 accordance with this order. Lead Plaintiffs shall serve and file
27 their second consolidated amended complaint by May 8, 2009.
28 Defendants shall respond by June 18, 2009. Any motion to dismiss

1 shall be noticed for August 20, 2009 at 2 p.m. The opposition to
2 Defendants' motion to dismiss shall be filed on July 16, 2009, and
3 any reply brief is due July 30, 2009. A further case management
4 conference will be held on August 20, 2009 at 2 p.m., even if no
5 motion to dismiss is filed.

6 IT IS SO ORDERED.

7
8 Dated: 4/6/09



CLAUDIA WILKEN
United States District Judge